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Hedge funds triggered the vortex of panic

Their aggressive leverage hurt good stocks

Chicken Little has been squawking far too much these days. Ever since the acorn dropped on his head, it's been a constant cry of: "The sky is falling! The sky is falling!" Unfortunately the squawking has panicked many investors, causing them to sell stocks irrationally in the hope that it will lead them to safety.

It's true that stock prices have taken a beating but, before we allow investors to react to the squawking, and sell their holdings in good companies, I think they'd benefit from seeing how less visible forces helped nudge the acorn out of the tree. Many people are blaming the credit crunch and global economic slowdown without looking further. I think we should be explaining the impact of background culprits like the more complex investment products.

Some analysts are pointing to members of the hedge fund industry. Hedge funds were initially designed to provide sophisticated, institutional-style portfolio management to retail and institutional investors who could offset potential losses by hedging their investments through selling short and using derivatives, but recent events indicate that many haven't been successful in protecting downside risk.

When the markets first tumbled in 2007 some investors got scared and took the axe to their portfolios, scanning their holdings and chopping anything that was even remotely associated with stocks. Hedge funds were among the first to go.

Unfortunately, when hedge funds receive a lot of redemptions they must sell stocks in order to cash out the investor. This means the largest and most liquid holdings in a hedge fund are dumped onto the market, placing downward pressure on stock prices. If the hedge funds used extensive leveraging in their investment strategies, the consequences worsen.

It was inevitable that the markets would react negatively to the credit crunch and global economic slowdown but I doubt that we would've seen such huge declines if not for excessive leveraging in some hedge funds. De-leveraging has fueled the fire. Investors take flight for safety, hedge funds suffer redemptions, and de-leveraging sucks a normal redemption into the abyss. Worst of all, the selling causes a vortex of panic among retail investors, further increasing downward pressure.

In September alone, hedge fund redemptions exceeded $43 billion. This is sufficient, given the normal leverage at hedge funds, to trigger more than $200 billion of stock sales and generate a serious impact on markets worldwide. Many companies, whose shares were widely held by hedge funds, have suffered large share price decreases - not because the companies weren't solid but because of high-volume selling.

Consider General Electric, which has experienced a lot of selling pressure from hedge funds and year-to-date is down over 50%. Warren Buffett, arguably the world's smartest investor, sees a lot of value in the company and recently made a $3 billion investment in it. Even with that huge vote of confidence, the stock price has continued to drop but I doubt that Mr. Buffett is concerned. He's looking forward to the day GE returns to its real value.

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Whether or not you use hedge funds in your clients' portfolios, they should be made aware of hedge fund implications because fund actions have a direct impact on investor holdings. You should not allow the effect of hedge fund redemptions on share prices to cause your investors to conclude that their holdings are less valuable. Rather, if they're sitting on cash, you might ask them to think about Mr. Buffett's approach and look for good stocks now at bargain basement prices.

If your clients are long-term investors and have funds available, I strongly encourage you to have them put the money to use. If you examine the last 9 bear markets dating back to the 1950s, the average decline has been approximately 32%, with the average length about 13 months. Comparing the S&P 500's peak at 1,565 points last year to the S&P 500 today, the markets have currently declined even more over 13 months, creating a buying opportunity.

Warren Buffett recently wrote an op-ed piece in the New York Times encouraging long-term investors to buy US equities. He quipped, "Be fearful when others are greedy, and be greedy when others are fearful". Our clients should be guided in their purchases to companies with strong fundamentals, the companies who will not only survive but will continue to grow. If there are further declines in the markets we should explain 'averaging down' so that clients can use cash to reduce the average price per share and increase their gains as markets recover.

Finally, as an Investment Advisor, I believe it's also important for clients to understand that not all hedge funds are leveraged. It should be stressed that there are many excellent hedge funds on the market that use little or no leverage but unfortunately their reputations have been tarnished by some of their more aggressive peers.

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